Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Alquist, et. al	Analyst:	Kimberly Pantoja	Bill Number:	AB 1174
Related Bills:	See Legislative History	Telephone:	845-4786	Amended Date:	04/02/01
		Attorney:	Patrick Kusiak	Sponsor:	Lt. Governor Cruz Bustamante

SUBJECT: Higher Education Tuition, Fees, and Related Expenses Refundable Credit

SUMMARY

This bill would create a refundable tax credit for the costs of higher education.

SUMMARY OF AMENDMENT

The April 2, 2001, amendments do the following:

- specify a repeal date of December 1, 2009;
- allow the credit to the taxpayer or any dependent of the taxpayer, rather than just the taxpayer's child;
- specify that the taxpayer may claim the credit for a maximum of four years (consecutive or nonconsecutive); and
- require the California Student Aid Commission to provide the department with the names and social security numbers of the individuals that are eligible to claim the credit.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to offset the costs of higher education for families that fail to obtain a Cal Grant but are within 150% of the maximum income threshold for Cal Grant eligibility.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective upon enactment. The credit would be operative for taxable years beginning on or after January 1, 2001, and before January 1, 2009.

POSITION

Pending.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Gerald H. Goldberg	05/15/01
____ N	____ OUA	__X__ PENDING		

Summary of Suggested Amendments

An amendment is suggested to provide appropriation language to fund the departmental costs associated with administering the proposed credit.

ANALYSIS

FEDERAL/STATE LAW

Federal and state laws allow an individual who pays qualified higher education expenses to exclude from gross income any amount of income received from any qualified U.S. savings bond, as defined.

Federal and state laws allow favorable tax treatment for taxpayers that save for college on a prepaid basis using a qualified state tuition program. These programs are established and maintained by a state or agency that meets specified requirements.

Federal law allows a deduction for costs incurred to maintain or improve skills required for the taxpayer's current business or employment, but not the costs incurred to meet minimum requirements for a trade or profession or to qualify for a new trade or profession.

Existing federal law provides two other types of education-related tax incentives: the Hope credit program and the Lifetime Learning credit program. The Hope credit program allows qualified taxpayers a nonrefundable credit of 100% for the first $1,000 of qualified tuition and related expenses, and a 50% credit for the next $1,000 of qualifying expenses, for a total credit of $1,500 each year per student. Beginning in 2001, the credit is indexed for inflation. The tax credit is phased out for single taxpayers with a modified adjusted gross income of between $40,000 and $50,000 and for joint filers with adjusted gross income of between $80,000 and $100,000. The Hope credit may be claimed for an eligible student for only two taxable years.

The Lifetime Learning credit program allows taxpayers a nonrefundable 20% credit for up to $5,000 per taxpayer in qualified tuition and related expenses for graduate and undergraduate courses at an eligible education institution. The phase-out provisions for this credit are the same as those for the Hope credit. There is no limit to the number of years that a Lifetime Learning credit may be claimed.

Both state and federal laws provide various tax credits designed to provide tax relief for taxpayers that must incur certain expenses (e.g., renter's credit) or to influence behavior, including business practices and decisions (e.g., research credits).

Existing state law provides general rules that apply to the division of credits among two or more taxpayers, a husband and wife, and partners.

THIS BILL

Under the Personal Income Tax Law (PITL), this bill would allow a credit for an amount equal to the cost paid by a qualified taxpayer for tuition, fees, and related expenses at any qualifying educational institution on behalf of the taxpayer or any dependent of that taxpayer.

The bill defines "qualified taxpayer" as a taxpayer whose taxable income is within 150% of the maximum limit set for obtaining an award from the Cal Grant Program and the taxpayer or the taxpayer's dependent is denied or otherwise ineligible for an award from the Cal Grant Program.

The bill defines "qualifying educational institution" as any university, college, or vocational school in this state.

The bill specifies the taxpayer may claim the credit for only four years, consecutive or nonconsecutive. The credit amount cannot exceed an aggregate total of $1,500 for each taxpayer, regardless of the number of dependents for which eligible expenses have been paid or incurred.

This bill specifies that any credit in excess of the taxpayer's tax liability would first be credited against other amounts due, and the balance, upon appropriation by the Legislature, would be refunded to the taxpayer.

This bill specifies that the California Student Aid Commission will provide the department with the names and social security numbers of all individuals that are eligible for the credit.

CAL GRANT PROGRAM BACKGROUND

The new Cal Grant program, which becomes effective in the upcoming 2001-2002 academic year, guarantees college financial aid awards to graduating high school students who meet the program eligibility requirements such as grade point average (GPA) and family income limitations.

Cal Grant A is awarded to students with a GPA of 3.0 or better, while Cal Grant B is awarded to students with a GPA of 2.0-3.0. Cal Grant B is available only to students with lower family income while Cal Grant A is available to students with higher family income. There is also a new Cal Grant for community college students who transfer to a four-year college.

Family size	Cal Grant A Income Limitation	Taxable Income Limitation
Family of four	$68,202	$102,303
Family of three	$62,776	$94,164
Single	$25,004	$37,506

Family size	Cal Grant B Income Limitation	Taxable Income Limitation
Family of four	$35,857	$53,786
Family of three	$32,239	$48,358
Single	$25,004	$37,506

IMPLEMENTATION CONSIDERATIONS

The term "fees" is undefined. It is unclear whether the author intends "fees" to include only the fees for college units (actual courses) or if fees would include all other annual fees and costs that may be incurred while attending an educational institution. Such costs could include parking fees, student association fees, or club fees. The term "related expenses" also is not defined. Therefore, it could include a broad range of "related expenses" such as books, supplies, housing, and transportation. To ensure the bill is administered as the author intends and to avoid taxpayer disputes, these terms should be defined.

The bill specifies that a qualified taxpayer must have "taxable income" within 150% of the maximum limit set for obtaining an award from the Cal Grant Program. For income tax purposes, "taxable income" is adjusted gross income (AGI) minus either the standard deduction or the taxpayer's itemized deductions whichever is higher. The department currently does not capture "taxable income" amounts. Capturing this information would have a significant impact on the department's programs and administrative costs.

The taxpayer may claim an aggregate credit of $1,500 over four years, either consecutive or nonconsecutive. This limitation may be difficult to administer, particularly if the credit is claimed for nonconsecutive years. The department would be required to retain data regarding the amounts of credit claimed for years for which the statute of limitations would have expired.

The California Student Aid Commission (Commission) would be required to forward the names of all individuals eligible for the credit to the department for verification. This provision would require the Commission to keep track of students who are denied awards and their income information. However, if students do not apply for a Cal Grant, the Commission would not have those names on record. In addition, information regarding whether the student actually attended an educational institution would be required. It is unclear if the Commission would be able to provide this information. Since the Commission cannot be expected to have complete and accurate information on students who are ineligible, a more effective means of verifying the eligibility would be useful.

The Commission also would be required to forward the social security numbers of all individuals eligible for the credit to the department. However, the department does not capture the social security numbers of dependents; therefore, the department would not be able to use the social security numbers of dependents for verification purposes as the author intends.

The bill does not specify that the information to be provided to FTB be transmitted in any given media (e.g., magnetic tape or other machine-readable form) or in a form and manner agreed upon by FTB.

The bill specifies the amount of the credit cannot exceed an aggregate amount of $1,500 per taxpayer. It is unclear how this limitation would affect the different filing statuses. For example, a married couple that files "married filing separate" could each claim the $1,500 credit. Clarification on this issue is needed.

This bill would require regular appropriations by the Legislature to pay for the refundable portion of this credit. If sufficient funds were not appropriated to cover all of the refunds due, the department would suspend payment of the refunds until additional funds were appropriated. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

Since the proposed credit is refundable, the credit calculation would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540 2EZ. This would increase the size of PIT return Forms 540, 540NR, 540X, and potentially the 540A, by one page. This would result in a significant impact on FTB's operations and costs. Adding a page to these returns will slow the processing of the returns and require additional storage space. While the department would work within available space to the extent possible, leasing additional office and file storage space may be necessary.

LEGISLATIVE HISTORY

AB 1441 (Wayne, 1997/98) would have created a tax credit for university tuition and fees. This bill was held in the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The laws of the following states were reviewed because their tax laws are similar to California's income tax laws.

Michigan allows taxpayers with an AGI of $200,000 or less to claim a personal income tax credit for 8% of all fees and tuition paid to a qualified institution of higher learning, not to exceed $375 per student for each tax year. The credit may not be claimed for more than four years for any one student. The Department of Treasury may require reasonable proof of payment, and the credit must be claimed on a separate income tax form. The student must attend a Michigan institution of higher education that certifies that tuition will not increase in the ensuing academic year by the preceding year's rate of inflation.

New York allows a refundable credit for college tuition expenses phased-in over a four-year period beginning in tax year 2001 for full-year resident taxpayers. Alternatively, for taxpayers that choose not to use the credit, a personal income tax itemized deduction can be claimed instead.

Illinois allows a taxpayer that is the parent or custodian of a qualified pupil a personal income tax credit for qualified education expenses. Expenses are defined as those costs in excess of $250 that are incurred on behalf of a pupil for tuition, book fees, and lab fees at an elementary or secondary school in which the pupil is enrolled during the regular school year.

Florida and *Texas* do not allow an education expense income tax credit.

FISCAL IMPACT

First year implementation costs are estimated to be $1.4 million, which includes one-time programming costs of approximately $244,000. Ongoing costs are estimated to be $1.1 million to process this credit. It is estimated that this bill would require the department to incur 31 additional personnel years (PYs) in 2001-02, and approximately 28 PYs in the ongoing years. The department would have to begin working on programming immediately to process this credit for the 2001 taxable year.

The estimated costs are associated with the return validation and processing of the refundable credit, programming changes to the PIT computer system, and increased taxpayer telephone calls and correspondence.

Amendment 1 is provided to suggest language for an appropriation to fund these departmental costs.

ECONOMIC IMPACT

Tax Revenue Estimate

This bill would result in revenue losses as follows:

Estimated Revenue Impact of AB 1174 As Amended April 2, 2001 ($ Billions)		
2001-02	2002-03	2003-04
-$2.5	-$1.2	-$1.3

The income measurement used for this analysis is based on California AGI. If taxable income were the measurement used, projected revenue losses would increase due to a higher percentage of taxpayers meeting the Cal Grant income limitation.

No adjustment was made for students receiving financial aid other than Cal Grants, such as full scholarships, etc., since the bill is silent in regards to this issue.

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Estimate Discussion

The impact of this bill would depend on the number of taxpayers qualified to claim the credit and the amount and nature of qualified fees and expenses allowed.

The author has indicated that it is the intent of the bill to allow expenses such as tuition, fees, books and materials, students housing, etc., in the category of allowable expenses and these expenses have been included in this revenue estimate.

The total number of students in California universities, colleges, and vocational schools is projected to be 2.2 million in 2001, including undergraduate and graduate students. No incentive effect from this credit was included in the estimate for 2001 but an incentive effect was included in subsequent years, the highest being an additional 10% increase in students attending community colleges. The projected revenue loss includes the impact of both resident and nonresident students.

For each category of students, based on the type of educational institution attended, projected school fees and related housing expenses exceed the proposed $1,500 per taxpayer credit limitation. Therefore the total $1,500 credit was applied for all projected eligible students in 2001 and for all projected new or newly eligible students in subsequent years. Included in the number of projected newly eligible students is the estimated number of graduate students claimed as a dependent in earlier years but independent in later years, approximately 50% of projected graduate students. This bill does not limit allowable credits generated by one student, it limits the credit to one per taxpayer claiming the credit.

The bill does not specify which Cal Grant income limitations to use when applying the 150% maximum income limitation. The bill specifies, "taxable income is within 150% of the maximum limit set for obtaining an award pursuant to the Cal Grant Program". Therefore Cal Grant A with the highest income limitations was used in the computation of the anticipated impact of this income limitation. It is projected that 80% of eligible taxpayers will meet the 150% maximum Cal Grant A income limitation. The approximately 46,000 students receiving Cal Grants each year were excluded from the students eligible to claim this credit.

Information from the California Postsecondary Education Commission, the Association of Independent Colleges and Universities, and in-house sources were used in the development of this revenue estimate.

ARGUMENTS/POLICY CONCERNS

Historically, refundable credits, such as the former state renter's credit and the federal Earned Income Credit, have had significant problems with invalid and fraudulent returns. These problems are aggravated if a refund is made that is later determined to be fraudulent. In such cases, the refund commonly cannot be recovered. However, fraud concerns are reduced with this credit due to the narrow criteria for claiming the credit.

Credits generally are provided as a percentage of amounts paid or incurred. This bill would allow a 100% credit, which is unprecedented.

The credit is limited to an aggregate total of $1,500 per taxpayer, regardless of the number of dependents of that taxpayer attending qualified educational institutions.

Basing the allowance of the credit upon the taxable income of the taxpayer rather than the AGI of the taxpayer would put taxpayers that do not itemize deductions at a disadvantage. Taxable income is adjusted gross income minus either the standard deduction or the taxpayer's itemized deduction whichever is higher.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1174
As Amended April 2, 2001

AMENDMENT 1

On page 3, line 1, following "SEC. 2" insert:

(a) There is hereby appropriated from the General Fund for expenditure in the 2001-2002 fiscal year the sum of one million four hundred thousand dollars ($1,400,000) for allocation to the Franchise Tax Board in augmentation of Item 1730-001-0001 of the Budget Act of 2001.
(b) Any funds that are allocated pursuant to subdivision (a) shall be expended by the Franchise Tax Board solely for the purposes of administration of the Higher Education Opportunity Refundable Credit under Section 17053.51 of the Revenue and Taxation Code.
SEC. 3.